

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-111817-07

Program Manager, ATCL Operations

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conference:

LEGEND:

Parent =
Taxpayer =
Date 1 =
Date 2 =
Years 1 =
Years 2 =

ISSUE:

Whether Taxpayer must recognize income from reimbursement of allowable costs under § 451 of the Internal Revenue Code as allowable costs are incurred under its cost-plus service contracts with the United States Government?

CONCLUSION:

Taxpayer is not required to recognize income from reimbursement of allowable costs under § 451 as allowable costs are incurred under its cost-plus service contracts with the United States Government.

FACTS:

On Date 1, Taxpayer, an accrual method taxpayer, was acquired by Parent and became a wholly-owned subsidiary of Parent. This technical advice relates specifically to taxable years of Taxpayer that preceded the time when Taxpayer was acquired by Parent.

As part of Taxpayer's business operations, Taxpayer enters into various types of contracts with the United States Government (Government). One way of classifying these contracts is based on the nature of the work to be done, as follows: (1) contracts to produce hardware; (2) contracts to perform technical services; and (3) contracts requiring both the production of hardware and the performance of technical services ("mixed contracts").

Taxpayer's contracts with the Government generally fall within one of two broad categories based on the pricing terms of the contracts: (1) fixed-price contracts and (2) cost-plus contracts. Under fixed-price contracts, the Government generally agrees to pay the contractor a fixed fee for work related to the contract. Under cost-plus contracts, the Government agrees to reimburse the contractor for its costs and to separately negotiate and pay the contractor a profit fee for work related to the contract.

In Date 2, Taxpayer received permission to change its method of accounting for recognizing service income for all its contracts with the Government to the accrual method. Taxpayer had previously used the percentage of completion method (PCM) for book and federal income tax purposes. The method change granted did not specify how the taxpayer should apply the accrual method to its service income.

For the taxable years of Years 1, Exam determined that all of Taxpayer's unbilled receivables related to its service contracts must be included in taxable income. Taxpayer disagreed with this approach and argued that the proper time to accrue service income is when amounts become due under the contracts. Because no agreement could be reached on the issue, Taxpayer has taken the case to the Appeals Office. Since that time, Exam has changed its position and is limiting its adjustment to only income from Taxpayer's cost-plus contracts. Furthermore, Exam has also limited its adjustment to income from reimbursable costs under such contracts. Thus, exam is no longer disputing that the profit fees under Taxpayer's cost-plus contracts are included in income as amounts become due. Currently the same issue is before the Appeals Office for the taxable years of Years 2.

With respect to service contracts entered into by Taxpayer with the Government, the technical services performed by Taxpayer include research and design services, information technology services, engineering and consulting services, training services, and operational services. The contracted services generally involve research and development projects for the Government.

Government cost-plus contracts are generally governed by the Federal Acquisition Regulations (FAR), which provide the terms included in each contract. For cost-plus contracts, FAR provides for payment of allowable incurred costs to the extent prescribed in the contract. These contracts establish an estimate of total allowable costs for the purpose of obligating funds and establishing a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer. The estimate of total allowable costs also includes a billing rate for indirect (overhead) costs allowable under the contract.

In the case of cost-plus contracts for services, FAR permits the contractor to submit interim bills to the Government authorizing the Government to make interim payments to the contractor no more often than once every two weeks for 100% of the allowable costs that the contractor has incurred in doing work on the contract since the previous interim bill.

Under FAR, a cost-plus contract may be used only when: (1) the contractor's accounting system is adequate for determining costs applicable to the contracts, and (2) the appropriate Government surveillance during performance will provide reasonable assurance that efficient methods and effective cost controls are used. Further, the accounting system must also be able to identify unallowable costs and exclude them from billings, claims or proposals.

In addition to the reimbursement of costs, cost-plus contracts ordinarily include one or more types of contract fee provisions. The type of contract fees include no fee, fixed fees, incentive fees, and award fees. Typically, the contract will authorize interim billing and payment of ratable portions of the contract fee during the period of time when the work required by the contract is being done.

Under FAR, cost-plus contracts for services generally incorporate an Inspection of Services clause. The clause generally provides that the Government has the right to inspect and test all services called for by the contract. If any of the services performed do not conform to contract requirements, the Government may require the contractor to perform the services again in conformity with contract requirements, for "no additional fee." The clause does not provide that the contractor will not be entitled to reimbursement for its prior costs or any additional costs in correcting defects.

When the defects in services cannot be corrected by re-performance, the Government may: (1) require the contractor to take necessary action to ensure that future performance conforms to contract requirements; and (2) reduce any “fee” payable under the contract to reflect the reduced value of the services performed. If the contractor fails to promptly perform the services again or take the action necessary to ensure future performance in conformity with contract requirements, the Government may: (1) by contract or otherwise, perform the services and reduce any fee payable by an amount that is equitable under the circumstances; or (2) terminate the contract for default.

If the Government terminates a cost-plus contract for default, it may make an appropriate reduction in total “fee.” However, the FAR termination clause specifically provides that the contractor, in a default situation, is reimbursed its allowable costs up to the effective date of the termination.

The Government may also terminate a cost-plus contract for convenience. In those cases, the Government usually terminates the contract because it believes the project is no longer viable or it would prefer to spend its funds on other projects. The FAR termination clause, in a convenience termination situation, allows the contractor to be reimbursed its allowable costs up to the effective date of termination and to also receive an appropriate percentage of its fee as allowed under the contract.

LAW AND ANALYSIS:

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. See *also* § 1.451-1(a) of the Income Tax Regulations.

Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy, (the “all events test”). See *also* § 1.446-1(c)(1)(ii)(A).

Under the first prong of the all events test, all the events that fix a right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens first. See, e.g., Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 2003-10, 2003-1 C.B. 288; Rev. Rul. 84-31, 1984-1 C.B. 127. The terms of an agreement are relevant in determining when the all events test is met. *Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), *acq.* 1967-2 C.B. 2.

For the contracts in question, in the present case, the issue is whether Taxpayer must recognize service income related to reimbursable allowable costs as such costs are

incurred or whether service income is not includable in income until such cost amounts are due (billable) under a contract.

Generally, under most service contracts, income accrues when performance of the services is complete, not as the taxpayer engages in the activity. See, e.g., *Decision, Inc.*, 47 T.C. at 63. Taxpayer's facts are similar to those in *Decision, Inc.* The taxpayer in that case was in the publishing, advertising, and recruiting business, and most of its income was derived from the sale of advertising space in specialized publications, including a Job Directory. The taxpayer offered advertisers who purchased space in the Job Directory immediate use, upon execution of their advertising contract, of the taxpayer's resume service. An advertiser could request advertising space in the Job Directory without the resume service and in such a case there would be a \$100 reduction in the price of the advertising space. Orders for advertising in the job Directory were due by November 15, 1963, invoices were to be sent in January of 1964, and the Job Directory was to be published in February of 1964.

The Commissioner contended that income accrued upon performance of the resume services by the taxpayer even though by contract the payment for the performance was postponed. The Commissioner pointed out that although the 1964 Job Directory was not published until after the January 1964 billing date, the advertisers began receiving the resume service as soon as they placed their advertising orders in 1963. To the extent that the taxpayer provided the resume service during 1963, the Commissioner contended that the income attributable to those services accrued in 1963, even though the customers were not billed until 1964. The Tax Court, however, did not accept the Commissioner's argument that the taxpayer's right to receive income was fixed merely by performance of a portion of the services required by the contract. In holding that the taxpayer did not have a fixed right to receive income until the billing date, the Tax Court stated that the Commissioner "has referred us to no cases holding that income accrues upon part performance of a contract prior to an agreed billing or payment date." *Id.* at 63.

Thus, the general rule is that, prior to a payment being made or due to a taxpayer, the taxpayer's right to receive income is fixed only when the required performance occurs, and not when partial performance occurs. In the instant case, the issue is whether the required performance occurs prior to the billing date under Taxpayer's contracts with the Government. Exam argues that the required performance occurs as Taxpayer incurs costs in performing under a cost-reimbursement contract because Taxpayer will, in all circumstances, receive income representing the amount of its costs. Exam is not arguing that the fee income accrues as the costs are incurred. Thus, Exam's position depends on the cost portion of the cost-reimbursement contract being divisible from the rest of the contract.

Although income from a service contract generally accrues when performance of the services is complete, if the services are divisible, a portion of the income may be

allocated to each divisible service provided under the contract. *E.g.*, Rev. Rul. 79-195, 1979-1 C.B. 177. In Rev. Rul. 79-195, the Service concluded that a divisible portion of service income was earned before all the services under the contract were completed. The ruling involved a correspondence school that received federally guaranteed nonnegotiable promissory notes as payment for home study courses. Each course consisted of several lessons to be completed by a student over a period of 36 months. Under the terms of the tuition contract and nonnegotiable promissory note, the school's right to receive a tuition payment was conditioned upon the school rendering the educational instruction on a lesson-by-lesson basis and the student's completion of a lesson that was part of a course. No amounts were due or paid pursuant to the terms of the contract and promissory note until nine months after the student graduated or ceased to carry at least one-half of a normal full-time academic workload. If a student terminated a course before completion, only the tuition for the lessons completed would ultimately become due, and the student's note was reduced accordingly. If the student terminated a course before completing any lessons, there was no tuition charge and the student's note was cancelled.

In Rev. Rul. 79-195, the income accrued represented all of the income attributable to the portion of the services completed during the taxable year of the accrual. However, in the present case, the performance under the contract entitles Taxpayer to both cost reimbursement income and possible fee income attributable to the same performance. Accruing only the cost reimbursement income, as Exam's adjustment does here, presents a situation that is distinguishable from the revenue ruling. Instead of dividing the required performance under a contract into divisible services, as the Service did in Rev. Rul. 79-195, Exam is attempting to divide the required performance under a contract based on "divisible" components of the amounts to be billed under the contract. We are not aware of any authorities that permit divisibility based on components of the billable amounts for federal income tax purposes. Consequently, we do not think the required performance for the accrual of the cost portion of the billable amount differs from the required performance for the fee portion of the billable amount. For both amounts, the required performance has not occurred prior to the time the amounts under the contract are due. Therefore, Taxpayer does not have a fixed right to receive income under its Government contracts until the amounts become due.

CONCLUSION:

Taxpayer is not required to recognize income from reimbursement of allowable costs under § 451 as allowable costs are incurred under cost-plus service contracts with the United States Government.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.